JUN 6 1988

United States General Accounting Office

GAO

Report to the Honorable
Paul S. Trible, U.S. Senate

COMPLETED

March 1988

TAX POLICY

Federal Estate Tax on Historic Properties

GAO/GGD-88-56

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-214148

March 31, 1988

The Honorable Paul S. Trible
United States Senate

Dear Senator Trible:

In your December 1, 1986, letter, you noted a concern that federal estate tax could "pose a significant danger to the preservation of historical properties." You asked us to determine whether this concern is well-founded. This report reviews the effect of federal estate tax on historic properties and evaluates a proposal to provide some federal estate tax relief for historic properties transferred to heirs upon the death of the property owner.

As arranged with your office, we are sending copies of this report to the Commissioner of Internal Revenue, the Secretary of the Interior, and the National Trust for Historic Preservation. We also will make copies available to others upon request. If you have any questions, please contact Charles Vehorn of my staff on 272-7904.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Associate Director

Executive Summary

Purpose

Although in 1966 Congress enacted legislation to encourage the preservation of historic properties, historic preservationists believe the current federal estate tax provisions have an adverse effect on historic properties. They argue that federal estate tax obligations are forcing the breakup and sale of historic properties for incompatible uses, i.e., uses that remove them from the National Register of Historic Places or make them no longer eligible for listing. Senator Trible asked GAO to determine if this concern is well-founded. The objectives of GAO's review were to (1) document the extent to which historic properties have been broken up or sold for incompatible uses to pay federal estate tax obligations, (2) determine how current federal estate tax law applies to historic properties, and (3) evaluate a proposal to give preferential tax treatment to estates that contain historic property.

Background

The National Historic Preservation Act of 1966 was enacted to establish our national historic preservation program. This program encourages the preservation of our historic resources and promotes conditions in which historic properties can be preserved. In response to concerns that federal tax laws were adversely affecting preservation activities and undermining the purposes of the act, Congress in 1980 asked the Advisory Council on Historic Preservation to study the effect of federal tax laws on historic preservation. The study found that historic properties were being assessed and taxed at their "highest and best use" rather than at their historic value, which is often lower. The study also argued that there may be forced sales of historic property for uses incompatible with historic preservation because the tax must be paid quickly, usually within 9 months after the owner's death.

Results in Brief

Although GAO searched statistical data bases and made numerous inquiries of individuals and organizations involved in historic preservation activities, it did not identify any historic properties lost to preservation since 1976 because of the federal estate tax. The few properties suspected of being sold for estate tax purposes either were never listed on the National Register of Historic Places or were lost to preservation for other reasons—deterioration, fire, vandalism, or unacceptable modifications. GAO believes, however, it would be misleading to conclude that federal estate tax never caused the loss of historic properties because agencies are not required to keep records that document why historic properties were sold.

While the alleged problem could have been more pervasive before 1976, the estate tax laws have undergone certain changes since then that have provided indirect benefits to historic preservation.

In reviewing a proposal to reduce the estate tax burden on historic properties, GAO noted that the proposal does address the two most prominent concerns—high valuation and the short time frame before the tax is due. But the proposal does not contain a provision to recapture tax benefits if the properties are not preserved, nor does it obligate the heirs to maintain the property in its historic state.

GAO's Analysis

GAO identified several reasons, other than estate taxes, that may influence the sale of historic property upon the owner's death. These reasons include a desire of the heir or heirs to reap the benefits from the sale to a commercial developer, lack of interest in the property, disagreement among heirs, or high maintenance costs associated with the property. (See p. 13.)

GAO's analysis of estate tax data revealed that the number of taxable estates has declined rapidly since 1976. The Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981 reduced the burden of federal estate tax on historic property owners. These acts established (1) a filing threshold that currently exempts estates valued at $600,000 or less from any federal estate tax, (2) a maximum tax rate which was scheduled to drop to 50 percent in 1988 but is currently frozen at 55 percent, (3) an unlimited marital deduction, (4) the option to use easements, and (5) a special use valuation for family farms and closely held businesses. (See pp. 17-21.)

In reviewing the preferential tax treatment proposal, GAO found that other alternatives exist to protect historic properties. Some states have active preservation programs that provide information explaining various options open to historic property owners. (See pp. 28-29.)

Recommendations

GAO's analysis did not point to the need for recommendations.

Agency Comments

GAO did not obtain official agency comments. Internal Revenue Service, National Park Service, and National Trust officials did review a draft of this document and suggested some clarifications that GAO considered in preparing the final product.

Contents

Executive Summary		2
Chapter 1 Introduction		6
	Administrative Agencies	7
	Objectives, Scope, and Methodology	7
Chapter 2 Effect of Federal Estate Tax Cannot Be Quantified		10
	Data Not Available on Whether a Problem Exists	10
	Various Reasons Cited for Property Sales	12
	Historic Integrity of Properties Preserved	13
Chapter 3 Changes in Tax Laws Have Lessened the Adverse Effects of Federal Estate Tax on Some Estates		16
	Federal Estate Tax Computation and Filing	16
	Imposition of Estate Tax Is Limited	17
	Changes in Filing Threshold and Marital Deduction Reduced the Number of Taxable Estates	17
	Concern Centers on Valuation and Time to Pay	20
	Valuation Options Are Available to Reduce the Estate's Market Value	20
Chapter 4 Evaluation of Proposal		24
	Donation of Easement by Executor Provided	24
	Extension of Time to Pay Provided	24
	Proposal May Have Limited Effectiveness in Preserving Properties	25
	Provisions to Protect the Federal Government	26
	Alternative Ways to Protect Historic Properties	28
Appendix		
	Appendix I: GAO Letter of Inquiry	30
Table		
	Table 3.1: Estimated Number and Value of Total and Taxable Estates That Filed Returns, for Selected Years	19
Figures		
	Figure 3.1: Estimated Number of Estates Filing Returns for Tax Years 1977, and 1982 Through 1985	18
	Figure 3.2: Estate Tax Return Filing Requirements 1916-1987	19

Abbreviations

ERTA	Economic Recovery Tax Act
GAO	General Accounting Office
IRS	Internal Revenue Service
NPS	National Park Service
SHPO	State Historic Preservation Officer
SOI	Statistics of Income

Chapter 1

Introduction

The National Historic Preservation Act of 1966 was enacted to "establish a program for the preservation of additional historic properties throughout the Nation. . . ."[1] The national historic preservation program encourages the preservation of our historic resources and promotes conditions where properties can be preserved. In response to concerns that federal tax laws were adversely affecting preservation activities and undermining the purposes of the act, Congress in 1980 asked the Advisory Council on Historic Preservation[2] to study the effect of federal tax laws on historic preservation. In 1983, the National Trust for Historic Preservation[3] (National Trust) completed the study for the Advisory Council and reported that "even though a very small minority of decedents' estates are subject to federal estate and gift taxes, there is growing concern that important historic properties may be disproportionately and adversely affected by federal estate and gift taxes. . . ."[4]

According to National Trust officials, much of this concern is focused on the impact of estate taxes on private property, to which a great deal of America's heritage is tied. The National Trust study and some historic property owners maintain that historic properties are adversely affected by federal estate and gift taxes primarily because (1) historic properties are valued at their "highest and best use" for estate tax purposes rather than their lower historic use value, resulting in higher estate taxes; and (2) the pressure to pay federal estate tax within 9 months, coupled with a lack of liquid assets, compels the sale of the property to developers who use it for purposes incompatible with preserving historic designation.

In the Tax Reform Act of 1976 (Public Law 94-455), Congress recognized the existence of similar estate tax problems for farmers and owners of closely held businesses. A proposed Senate amendment had included historic properties, but the conference agreement omitted this proposal in the version of the bill that was enacted. Although there was

[1]Public Law 89-665, 80 Stat. 915.

[2]The Advisory Council on Historic Preservation was established in 1966 to advise the President and Congress on historic preservation matters and to encourage public interest and participation in historic preservation.

[3]The National Trust for Historic Preservation is a charitable, educational, nonprofit corporation which Congress chartered in 1949 to encourage public participation in the preservation of property of national significance or interest.

[4]The National Trust for Historic Preservation, Federal Taxation and the Preservation of America's Heritage, May 1983, p. II-4.

no discussion of the omission in the conference report, a National Trust official told us that a critical factor may have been that, as opposed to family farms and closely held businesses, most historic properties are not income-producing.

Subsequently, a proposal was developed which would extend preferential estate tax treatment to historic properties. This proposal, which is reviewed in chapter 4, has not yet been introduced in Congress, partly due to a lack of information on the extent of the problem.

Administrative Agencies

The National Park Service (NPS) administers the national historic preservation program. Each state, territory, and the District of Columbia has a State Historic Preservation Officer (SHPO) who works with NPS to carry out preservation programs at the state or local level. The National Trust for Historic Preservation accepts and administers donated properties and provides expertise, technical advice, and financial assistance to state and local historic preservation organizations, individuals, and community museums. Support for the National Trust is provided by membership dues, private contributions, endowment funds, and matching grants from federal agencies, including NPS.

IRS administers the federal estate tax provisions and is responsible for monitoring taxpayer compliance in this area. Generally, an automatic lien attaches to the estate to ensure that the federal estate tax liability is satisfied. State and local probate laws generally require that this liability be met before the property is cleared for transfer.

Objectives, Scope, and Methodology

We were asked by Senator Paul Trible to evaluate the effect of the federal estate tax on historic properties. The objectives of this study were to:

- document the extent to which historic properties have been broken up or sold for incompatible uses to pay federal estate tax obligations;
- determine how current federal estate tax law applies to historic properties, including the effect of changes made in 1976 and 1981; and
- review and evaluate a proposal giving preferential estate tax treatment to historic properties listed on the National Register of Historic Places (National Register), similar to that currently provided to family farms and closely held businesses.

The historic properties addressed in this report were privately owned, residential properties which were or are currently listed on the National Register.

We considered historic property to be adversely affected by federal estate tax if the property was destroyed, broken up into parcels that destroyed the property's historic integrity, or sold for incompatible uses in order to pay the tax. We considered historic property as sold for incompatible uses if it was sold for development purposes which changed the property in such a way that it was removed from the National Register or was no longer eligible for listing.

The Tax Reform Act of 1976 and the Economic Recovery Tax Act (ERTA) of 1981 (Public Law 97-34) made significant changes in the federal estate tax provisions and reduced the number of taxable estates and tax rates. Therefore, we focused our study on activities which occurred from 1976 to the present.

To address our first objective, we talked with NPS representatives and sent letters of inquiry to SHPOs in all 50 states and the District of Columbia. The letter requested information on any property which could possibly fit into our study. We sent the same letter of inquiry to state historical societies identified by the National Trust. We also discussed how the National Register is maintained with NPS officials and reviewed NPS files on historic properties which had been purged from the National Register to determine why the property had been removed. We also met with National Trust officials and reviewed the results of a 1986 inquiry they had sent to historic property owners and other preservationists. We contacted the appropriate SHPO for additional information on properties purged from the National Register and those identified from the National Trust inquiry as being adversely affected by estate taxes.

To address our second objective, we reviewed the Internal Revenue Code (Code) provisions on historic easements and federal estate tax, including the special use valuation available for family farms and closely held businesses. We reviewed major statutory changes to federal estate tax provisions in 1976 and 1981. To determine how these provisions are implemented, we reviewed IRS regulations, discussed filing instructions and guidance with IRS officials, and reviewed IRS' Statistics of Income estimates on federal estate tax.

To address our third objective, we discussed the provisions of a proposal giving preferential tax treatment to historic properties with IRS and NPS

officials, historic property owners, and estate tax lawyers. We compared provisions of the proposal with special use valuation provisions available to family farms and closely held businesses. During the course of our review, we identified alternative ways of achieving the objective of the proposal. While time did not allow us to review these alternatives in detail, we discuss them briefly in chapter 4. We also attended estate tax sessions of a National Trust conference on large historic estates.

We did our study between January and June 1987 and in accordance with generally accepted government auditing standards.

Effect of Federal Estate Tax Cannot Be Quantified

Although the potential exists for historic properties to be adversely affected by the federal estate tax, we found that statistical data are not available to either confirm the existence of a problem or to quantify its extent. We reviewed the data available from the National Register and the National Trust for the period 1976 to the present to determine how many properties had been lost to preservation in order to pay federal estate tax obligations. However, we were unable to identify any historic properties that had been sold for incompatible uses or broken up into parcels that destroyed the property's historic integrity. We also attempted to develop our own data through a letter of inquiry sent to SHPOs and historical societies. This effort was also unsuccessful in identifying any specific properties.

While we were unable to document cases where federal estate tax obligations had forced the sale of historic residences for incompatible uses, we cannot conclude that this has never occurred because information to document the reasons for the sale of historic properties is lacking. Neither NPS nor SHPOs are required to document this type of information. The lack of specific data, however, suggests that the problem is not pervasive at this time. The problem may have been more widespread before the 1976 Tax Reform Act and the 1981 Economic Recovery Tax Act. These acts have generally mitigated the adverse effect of federal estate tax by raising the estate value exempt from taxation (thus reducing the number of taxable estates), by reducing estate tax rates and by introducing historic easements.[1] Today, according to sources we spoke with, maintenance costs, high commercial values, and lack of interest of the heirs are more critical factors in the decision to sell historic properties upon the death of the owner than are federal estate tax obligations.

Data Not Available on Whether a Problem Exists

We pursued a variety of ways to document the extent to which historic properties have been lost due to federal estate tax obligations but were unable to identify any lost properties. We reviewed National Register files and responses to a 1986 National Trust inquiry, discussed the issues with experts in the preservation area, and sent inquiries to SHPOs and preservation groups.

The National Register, which is maintained by NPS, is a listing of properties which have historical, architectural, archeological, engineering, or

[1]A historic easement is a qualified conservation contribution of real property interest to a qualified organization exclusively for the preservation of historically important land or certified historic structures.

cultural significance to the nation as a whole, states, or local jurisdictions. States, local governments, or individuals may request that properties be placed on the National Register. NPS is responsible for reviewing applications and listing properties on the National Register. Properties identified as having particular national significance may be designated as national historic landmarks. Historic properties can be placed on the National Register individually or as part of a historic district. Properties listed on the National Register include buildings and structures such as houses, commercial buildings, and bridges; sites; districts; and objects such as monuments. The properties may be publicly or privately owned. Currently about 700,000 properties,[2] including 1,781 national historic landmarks, have been certified and placed on the National Register.

Data From National Register of Limited Value

Data in the National Register files were of limited value in identifying properties for this study. Neither changes in ownership information nor economic data, such as the value of properties, are noted in these files. NPS updates the files when it is notified that properties either no longer exist or no longer meet the criteria for inclusion on the Register. NPS, however, does not provide funds to the states for monitoring and reporting such changes. SHPOs who are asked to submit this information, therefore, must rely to a great extent upon notification from property owners. Because property owners have no incentives for reporting change of status, they may, therefore, fail to do so.

At our request, the NPS staff was able to identify 484 properties which had been removed from the National Register since its inception in 1966. Of these, we identified 27 as privately owned residential properties which had been removed since 1976. Reasons for the removal of 19 properties were identified in the NPS files and included fire, vandalism, or compromise of the historic integrity for such reasons as lack of maintenance. We contacted the SHPO in the states where the eight remaining properties were located. According to the SHPOs, none of the properties had been broken up into parcels that destroyed the property's historic integrity or had been sold for incompatible uses to pay federal estate tax obligations.

[2]This number represents individual properties listed as part of a historic district as well as the properties listed individually.

National Trust Inquiry Identified No Examples

In 1986, the National Trust attempted to develop information about the loss of historic properties through an inquiry sent to selected historic property owners who were members of the National Trust. The inquiry requested, among other items, specific examples of historic properties that had been broken up to pay federal estate tax obligations. From the responses to that inquiry, we identified properties which possibly fit our criteria and discussed them with various contacts in the appropriate state, including the SHPO. These contacts said that none of the properties fitting our criteria had been lost since 1976 due to federal estate tax.

Other Contacts Provided No Examples

The Director of the Center for Historic Houses of the National Trust provided us with approximately 80 personal referrals who might be helpful. We contacted 21 whom the Director identified as having a broad background in either historic preservation or estate taxes. While several people were very helpful in explaining the potential impacts of the federal estate tax, no properties were identified. After these contacts were unable to provide us with specific information on properties lost, and several said they knew the information did not exist, we did not pursue the remaining referrals.

Responses to GAO's Letter of Inquiry Cited No Examples

In addition, we attempted to develop our own data base of historic properties which had been broken up or sold for incompatible uses to pay federal estate taxes. To do this, we sent letters of inquiry to the SHPOs in all 50 states and the District of Columbia and to 50 National Trust historical society contacts in 43 states and the District of Columbia. The letter requested information on any property that might meet the criteria of this study (see app. I). We obtained responses from all of the SHPOs and 16 of the historical societies. As in our previous efforts, no specific properties were identified. The SHPOs in 20 states volunteered that their offices may not be notified of an ownership change or property sale, and they have no way of obtaining this information. According to the SHPOs we spoke with, many complex factors contribute to the sale of these properties, most of which are not likely to be publicly revealed. For example, if the estate has inadequate assets aside from the historic property to pay the estate taxes, the heirs may be reluctant to reveal this personal financial information.

Various Reasons Cited for Property Sales

While we were unable to quantify the impact of estate taxes on the preservation of historic properties, the various people we contacted, including the SHPOs and National Trust officials, identified a number of reasons

why historic properties may be sold, and ultimately the historic value destroyed, after the owner dies. We were also able to develop a profile for high risk properties.

Reasons given for the sale of historic properties after the owners' deaths included high commercial value of property, lack of desire by the heirs to retain ownership, conversion of the real estate to liquid assets which can easily be divided among the heirs, disagreements among heirs over the disposition of the property, and high maintenance costs associated with retaining the property.

Of these factors, the commercial value of the property is considered to be the major one influencing sales. The pressure to sell a historic property may be much greater in cases where the property includes land in or near a large metropolitan area. Circumstances caused by the property owner's death may increase the pressure to sell or break up the property.

Particular types of historic properties have a greater potential for being adversely affected by estate taxes. These include high-value properties that represent a large percentage of the total estate value, particularly those where the fair market value[1] has increased markedly since acquisition; properties located in or near developing areas with escalating fair market values; properties with limited income-producing potential; or properties included in estates for which there is little or no estate planning.

Historic Integrity of Properties Preserved

Although we were unable to identify properties lost to preservation, we did identify some historic properties that were sold since 1976 to pay federal estate taxes. However, all of these properties were preserved and their historical integrity maintained either through public or private ownership. A number of measures for saving properties were used. In some rural areas, properties were preserved through the family farm estate tax provisions (discussed in ch. 3), although opinions of the usefulness of this legislation differed widely. The Montana state legislature intervened in one case and enacted "forgiveness" of the state estate tax in return for taking over the property and preserving it. Ultimately, the

[1]IRS defines "fair market value" in section 20.2031-1(b) of its regulations as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

property will be open to the public. Some of the furnishings were auctioned to donors, who then returned them to the property. Sale of the furnishings and other private donations raised enough money to pay the federal estate tax. One large entrepreneur has arranged for his heirs to buy his property through income-producing businesses associated with the historic property. We were told of several instances where property was purchased by someone who appreciated its historic features and invested great sums of money to restore and maintain it. In one case, an estate which was sold to a commercial developer was kept intact by the new owner as his residence. One realtor who deals extensively with the sale of historic properties says unequivocally that estate taxes cause properties to be sold, but their historic character is not lost.

Despite the lack of concrete evidence, many of the knowledgeable people we contacted during the study believe that historic properties have been adversely affected by the federal estate tax. We were told that this "is not documented, but is general lore." Another said that she "wants to say Yes, there are a lot of properties," and she "was surprised that she could find none." A realtor, who we were told would have "smoking gun" examples, knew of properties which had been sold because of federal estate tax, but none were on the National Register. An attorney told us that "everybody knows the situation exists, but there is no magic list."

There appear to be several reasons for the inconsistency in what we were told and in what we actually found. First, if an estate includes a large amount of land, estate taxes may be paid by selling some of the land, sometimes leaving only a small piece surrounding the historic building. While this solves the estate tax problem for this generation, future generations of heirs may have more difficulty retaining the property. Second, as previously mentioned, there may be a reluctance on the part of heirs to publicize the type of personal and financial information needed to define the problem. Finally, and most important, there have been mitigating changes in estate taxation since 1976. As the 1983 report of the Advisory Council on Historic Preservation observed: "Recent changes in the estate and gift tax rates and coverage leaves [sic] somewhat in question the status of a longstanding preservation concern."[4] Despite the changes, there continues to be concern that federal estate tax has an adverse effect on historic properties.

[4]Advisory Council on Historic Preservation, Federal Tax Law and Historic Preservation, A Report to the President and the Congress, 1983, p. 13.

The following chapter details current federal estate tax provisions and the changes which have been made since 1976.

Chapter 3

Changes in Tax Laws Have Lessened the Adverse Effects of Federal Estate Tax on Some Estates

Federal estate tax provisions do not target historic properties for special treatment. Unless a historic property qualifies as a family farm or closely held business, is covered by a historic easement prior to the owner's death, or is located in a historic district, the property is valued and taxed in the same fashion as other real estate assets. Changes in federal estate tax provisions since 1976 have lowered the maximum tax rates and have significantly reduced the number of estates subject to taxation by providing for an unlimited marital deduction and by raising the filing threshold—the estate value level at which a federal estate tax return is required to be filed. Along with these changes, the charitable contribution provision in the 1976 Tax Reform Act providing for the protection of historic properties through easements appears to have further reduced the number of historic properties subject to federal estate tax. Nevertheless, concern still exists over the valuation procedures and time limits for payment contained in the federal estate tax provisions.

The federal estate tax, instituted by the Revenue Act of 1916, is a progressive tax imposed on the transfer of a decedent's estate to the heirs. One purpose of the tax is to redistribute wealth.[1] It is not a major source of federal revenues. In fiscal year 1986, the most current year for which actual data are available, IRS collected $6.8 billion in estate tax and related penalties and interest. This is less than 1 percent of the total revenue collected by IRS in that year.

Federal Estate Tax Computation and Filing

Computation of the federal estate tax is a multiple step process to determine the gross estate, taxable estate, gross estate tax, and net tax payable. All property in which the decedent has beneficial interest is included in the gross estate and is generally assessed at the fair market value. The taxable estate is the value of the gross estate less deductions, including the marital deduction,[2] unpaid mortgages, and other debts. The progressive tax rate which currently ranges from 18 to 55 percent[3] is applied against the taxable estate to determine the gross estate tax. In the final step, authorized credits are subtracted from the gross estate tax to determine the net estate tax payable.

[1]See Mary F. Bentz, "Estate Tax Returns, 1983," SOI Bulletin, Vol. 4, No. 2, (Fall 1984), p. 3.

[2]The marital deduction or bequest to surviving spouse is the value of property included in the decedent's estate that passes, or has passed, to the surviving spouse.

[3]The maximum rate was scheduled to drop to 50 percent in 1988. The Omnibus Budget Reconciliation Act of 1987, however, capped the maximum rate at 55 percent for the next 5 years.

The Internal Revenue Code requires that estate tax returns be filed and the taxes paid within 9 months of the decedent's death. Extensions for paying the tax are available under specific circumstances discussed later in this chapter.

Imposition of Estate Tax Is Limited

Only a small percentage of estates is required to file estate tax returns and not all are actually taxed. The executor of an estate is required to file an estate tax return if the value of the estate is over a certain threshold. For 1987 and later years, the threshold is $600,000.

Changes were made to the Code in 1976 and 1981 that reduced both the number of estates required to file tax returns and the number with tax liability. The effect of these changes is shown in figure 3.1. Between 1977 and 1985, the number of returns filed decreased by 66 percent and the number of taxable returns filed by 78 percent.

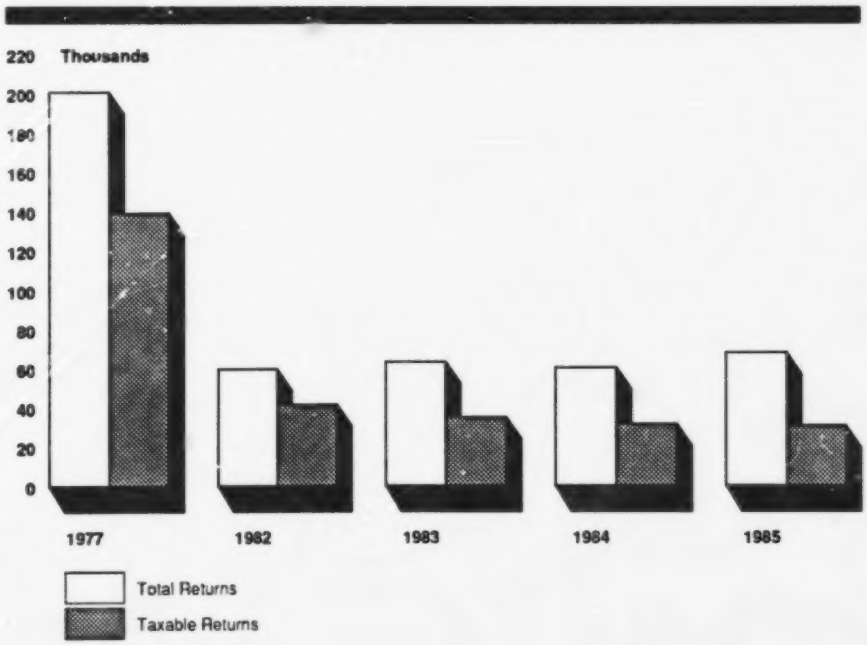
In 1926, only 1.1 percent of all deaths necessitated the filing of an estate tax return. By 1977, this figure had increased to 10.5 percent. Changes made in the estate tax code since 1976 reduced the percentage to 5.3 in 1983. This percentage is expected to further decline until the impact of the $600,000 maximum filing threshold level in 1987 is realized.

Changes in Filing Threshold and Marital Deduction Reduced the Number of Taxable Estates

The Tax Reform Act of 1976 increased the minimum value of estates subject to federal estate tax filing requirements from $60,000 to $175,000 to be phased in over a period of 5 years. The Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1984 (Public Law 98-369) further increased the filing threshold in increments to $600,000 between 1982 and 1987, and it reduced the maximum estate tax rate from 70 percent to 50 percent on the estates of persons dying in 1988 or later years. However, the lower maximum rate was not reached because the Omnibus Budget Reconciliation Act of 1987 capped the maximum rate at 55 percent. Figure 3.2 illustrates the changes in the size of gross estates required to file tax returns since 1916.

The 1976 act and ERTA also changed the once limited marital deduction for estate tax purposes. Before the 1976 act, up to one-half of the adjusted gross estate could be claimed as a marital deduction. In 1976, the marital deduction was changed to the greater of $250,000 or 50 percent of the adjusted gross estate. In 1982, the amount of the marital deduction became unlimited. With the unlimited deduction, the decedent may leave the entire estate to a surviving spouse with no federal estate

Figure 3.1: Estimated Number of Estates Filing Returns for Tax Years 1977, and 1982 Through 1985



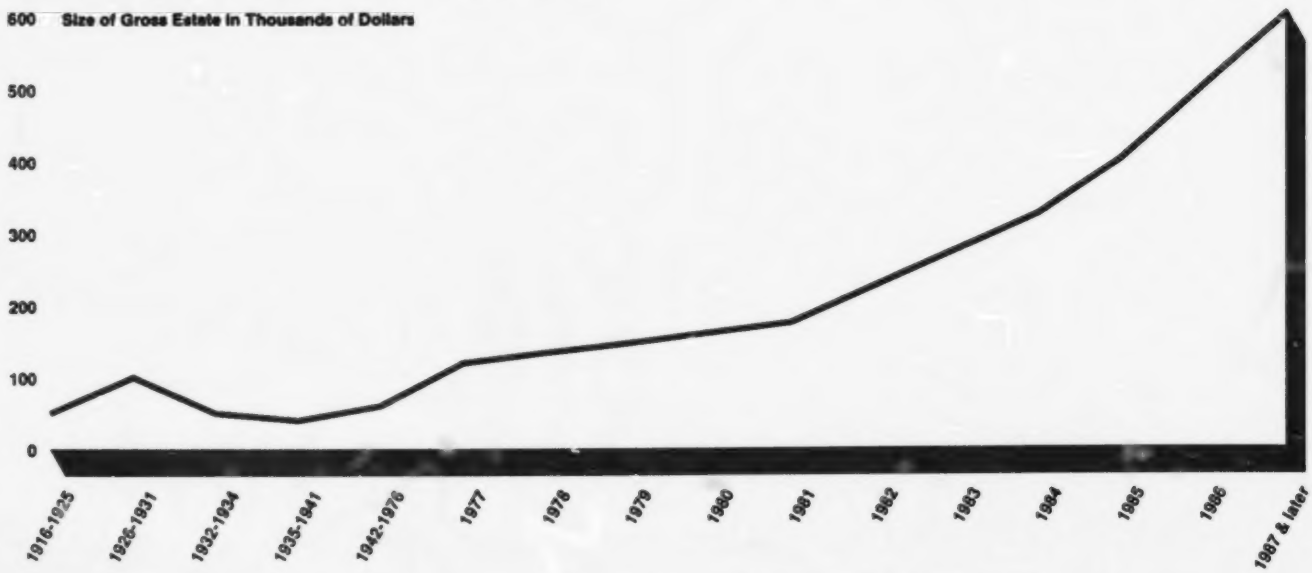
Note: Data for years 1982-1985 are limited to total returns for decedents with gross estates valued at $300,000 or more. This $300,000 level limitation thus lowers the estimated number of returns shown in this figure because returns filed during this period for estates under $300,000 were omitted.

Source: IRS Statistics of Income estimates based on samples of returns filed in tax years 1977, 1982, 1983, 1984, and 1985.

tax liability. According to IRS Statistics of Income estimates based on 1983 data, the marital deduction accounts for the largest portion (70 percent) of allowable deductions.

The effect of these changes can be seen in Statistics of Income estimates in table 3.1 which shows the number of estates required to file returns, the value of the gross estates, the number of taxable estates, the value of those estates having taxable returns, and the amount of estate tax due as reported on estate tax returns for selected years from 1977 to 1985.

Figure 3.2: Estate Tax Return Filing Requirements 1916-1987



Source: IRS Statistics of Income, SOI Bulletin, Vol. 4, No. 2, Fall 1984, p. 5.

Table 3.1: Estimated Number and Value of Total and Taxable Estates That Filed Returns, for Selected Years

	Total returns		Taxable returns		
Filing year	Number of estates that filed returns	Value of gross estates ($1,000,000)	Number of taxable estates	Value of gross estates ($1,000,000)	Estate tax after credits ($1,000,000)
1977	200,747	48,202	139,115	40,578	4,979
1982	59,597	45,412	41,620	37,767	6,226
1983	63,251	50,390	35,148	32,618	5,170
1984	60,316	49,954	31,507	30,187	4,667
1985	67,961	62,805	30,518	34,147	5,035

Note: Data for years 1982-1985 are limited to total returns for decedents with gross estates valued at $300,000 or more. This lowers the estimated numbers because the returns filed during this period for estates under $300,000 were omitted.

Source: IRS Statistics of Income estimates based on samples of preaudited returns filed in tax years 1977, 1982, 1983, 1984, and 1985.

In 1977, 69 percent of the total preaudited returns filed had taxable estates; this percentage had dropped to 45 by 1985 primarily due to the liberalization of the marital deduction. Partly as a result of other ERTA

changes, the average estate tax paid after all credits and deductions were taken increased from $35,791 in 1977 to $164,999 in 1985; in constant dollars, this was an increase of 160 percent. The average effective federal estate tax rate during the 1982-1985 time period was 15 to 16 percent.

Concern Centers on Valuation and Time to Pay

Property valuation for federal estate taxes is of interest to the National Trust and a major concern of some historic property owners. The value of an estate is generally based on the fair market value of the total estate at the time of the decedent's death and reflects the "highest and best use" value of the property. The value of a historic property for commercial use may be significantly greater than the value of the property as a historic entity. For estate tax purposes, the higher value is the fair market value.

An IRS estate and gift tax analyst told us, however, that he sees little need for statutory change to provide relief of federal estate tax for historic property owners because (1) current provisions of the Code have significantly reduced the adverse effect that federal estate tax may have had on some estates prior to 1981, and (2) historic property included in a decedent's gross estate is valued at the property's historic use value if it has a preservation easement or is located in a historic district with adequate property use controls.

Valuation Options Are Available to Reduce the Estate's Market Value

The 1976 Tax Reform Act contains two provisions that may be used under certain conditions to reduce the value of historic properties for estate tax purposes—(1) the special use valuation for family farms and closely held businesses, and (2) the allowance of a charitable deduction for historic easements.

Historic Property May Qualify for Special Use Valuation

The special use valuation provisions designed to reduce and defer federal estate tax on family farms and closely held businesses may also be applied to any properties, including historic properties, that meet the qualifying criteria.[4] Although this alternative was not established specifically to benefit the estates[5] of historic property owners, it provides a means by which an estate containing a qualified historic property may reduce and defer estate tax.

The executor of the estate may elect to use the special use valuation provisions available to family farms and closely held businesses to minimize and defer federal estate tax for qualified property. Once the election is made, the property is then valued as a farm or closely held business for estate tax purposes, rather than the fair market value based on the highest and best use of the property. Executors electing the special use valuation option may choose to pay the tax in annual installments over 10 years after a 5-year deferral period. The aggregate reduction in the fair market value of any single estate is limited to $750,000. Family heirs are then obligated to continue operating the farm or closely held business for at least 10 years after the election is made or be liable for payment of part or all of the reduced estate tax.

Less than 2,000 estates elected the special use valuation in any year during the period 1982 through 1985. Information is not available to determine if any of these estates contained historic property. The complexity of the qualifying limitations may have prevented estates with historic properties from making this election.

[4]The property must be qualified real property used for a "qualified use" by the decedent or a member of the decedent's family on the date of death under provisions of section 2032A of the Code. IRS defines "qualified use" as the use of property as a farm for farming purposes or the use of the property in a trade or business other than farming. Qualified real property includes real property improvements and residential buildings and other structures occupied or used on a regular basis by the owner or lessee for the purpose of operating the farm or closely held business. For the estate to be eligible for the special use valuation, (1) the property acquired by the qualified heir must account for at least 50 percent of the adjusted value (the value of property, without regard to its special use value, reduced by the balance of unpaid mortgages and any debts against the property) of the gross estate; (2) the adjusted value of the family farm or closely held business must account for at least 25 percent of the gross estate; (3) the decedent or the decedent's family must have owned the property and operated it for a qualified use for at least 5 years out of the 8-year period preceding the decedent's death; and (4) the decedent or the decedent's family must have materially participated in the operation of the farm or closely held business for at least 5 years out of the 8-year period preceding the decedent's death.

[5]"Estates" refer to the person's total assets at time of death, not to the historic property.

Historic Easements Can Ensure Historic Use Valuation

Under current law, historic property owners may establish preservation easements before death to minimize federal estate tax and to protect the property in perpetuity. The Tax Reform Act of 1976 granted taxpayers a charitable contribution for preservation easements. Under sections 170(f) and (h) of the Code, the owner of a historic property can donate an easement to a qualified organization exclusively for conservation purposes to protect the property in perpetuity.

The deed of easement, an agreement between the property owner and the holder of the easement, identifies features of the property to be protected and imposes restrictions on the use of the property. The terms of the easement provide for periodic inspection by the holder and the legal means for enforcing the agreement if the owner fails to comply with the terms. Deeds of easement are recorded in local land records and protect against sale for development.[6] The easement limits the uses of the property in perpetuity to those compatible with its historic character. Changes can be made to the property only with the approval of the organization holding the easement. In return, the owner of the property is allowed to take a charitable income tax deduction on the difference between the value of the property before and after the donated easement. Under current law for estate tax purposes, the easement must be put in place before the death of the owner or be contained as a bequest in his or her will.

Because of the restrictions placed on the property, a historic easement may result in lower taxes if the historic use value is lower than the fair market value without an easement.

Extensions of Time to Pay Are Available

Some historic property owners were concerned that the executor for the estate must pay the federal estate tax within 9 months of the decedent's death. The executor may, however, obtain extensions of time to pay the tax. IRS usually grants a 12-month extension. However, the executor may obtain extensions for up to 10 years at IRS' discretion if the executor demonstrates that payment of any part of the tax by the due date imposes "undue hardship" on the estate.

In practice, the term "undue hardship" means more than a general statement of hardship or merely a showing of reasonable cause. The need to sell property at the current fair market value in order to pay the tax

[6]Easements and Other Legal Techniques to Protect Historic Houses in Private Ownership, Thomas Coughlin, Historic House Association of America, 1981, p. 6.

generally does not demonstrate undue hardship. The following is cited in IRS regulations as an example illustrating undue hardship:

"The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due."

Because the extensions are discretionary, IRS grants them based upon examination of the facts in each case. However, one attorney in private practice told us that "undue hardship" as currently applied is difficult to demonstrate. The criteria for these extensions are stringent according to IRS, but not difficult to meet if qualifying criteria exist for the estate.

Although changes in federal estate tax provisions in 1976 and 1981 have lessened the adverse effect of this tax on some estates, there is still concern that historic properties are being lost to preservation because of federal estate tax obligations. A proposal has been prepared to address this concern and is discussed in the next chapter.

Chapter 4

Evaluation of Proposal

The proposal we evaluated provides preferential estate tax treatment for historic properties listed on the National Register. This proposal provides for the donation of a historic easement on the property by the executor of an estate, thus granting post-death benefits for the estate that previously could have been obtained only through pre-death estate planning by the property owner. The proposal also provides for the payment of the estate tax on historic property over a 15-year period. In return for the preferential tax treatment, the proposal requires that the properties be open to the public. While these provisions could provide relief from estate tax in certain cases, we found that the proposal may not be as effective as anticipated. Further, we noted that the proposal does not contain certain controls to protect the interests of the federal government like those contained in the special use valuation for family farms and closely held businesses.

Donation of Easement by Executor Provided

The proposal would allow the executor of the estate to donate an easement after the death of the owner but before the property is valued for the purpose of assessing federal estate tax obligations. This provision would benefit those properties not already covered by easements and whose historic value is less than their fair market value. How much the estate would benefit depends on the difference between the two values and the applicable estate tax rate. In some cases, however, the fair market value of the property may be the same as the historic use value.[1] In our discussions with property owners and legal experts in the field, we were told that while some of the nation's historic properties are covered by easements, many are not. Reasons for not donating easements included the owners desire not to give away part of their ownership rights, lack of estate planning, lack of available information on easements, and uncertainty over whether IRS would agree with the valuation of the easement.[2]

Extension of Time to Pay Provided

To address the concern that historic properties are being sold at "forced sales" to pay federal estate tax within the normally required 9-month period, the proposal would extend the time allowed for payment of estate tax on the historic property to 15 years. The executor can elect to pay the tax in installments over this period of time, rather than having

[1]This is particularly true in areas where great economic benefits accrue from tourism.

[2]Historic property owners told us of lengthy, costly valuation disagreements between IRS and well-respected property appraisers. This occurred because appraisals are subjective and there are few guidelines for establishing values of unique historic properties.

to plead undue hardship. The amount of tax eligible for the payment extension would be limited to the ratio of the historic property value to the estate's adjusted gross value. Interest charges on the outstanding tax would be set at the prime rate to make the deferral provision revenue-neutral for the federal government. (These provisions are not precisely the same as those for family farms and closely held businesses.)

Under present law, payment extensions are granted at IRS' discretion based on its review of each case. IRS usually grants a 12-month extension if the executor shows reasonable cause for the additional time. Additional 1-year extensions may be obtained for up to a total of 10 years only if the executor can show that the estate will suffer "undue hardship."

Proposal May Have Limited Effectiveness in Preserving Properties

According to property owners, legal experts, and other people we interviewed, the proposal may not be as effective as anticipated for several reasons.

First, where historic properties are the major assets in the estates, little or no money may be available to pay even the reduced estate taxes without selling the property. For example, some historic property owners pointed out that funds may not be readily available to pay federal estate tax because the owners often need to use available funds for property improvements and maintenance.

Second, we were told that many properties are sold because there are numerous heirs and no other way to divide the assets. In these instances, it may be difficult to get unanimous agreement among the heirs to donate an easement.

Third, sometimes the contents of a historic property are at least as valuable as the structure and the land. Furnishings and other artifacts may be an integral part of the historic character associated with the property. While a large portion of the estate's value may be attributed to these items, the proposal does not address this issue because the value of the historic structure, not the furnishings, would be protected.

Fourth, the public access provisions of the proposal are viewed by some as excessive. The property would have to be available to the public 8 hours a day, 5 days a week, 8 months a year. Benefits provided by the proposal are not perceived as being sufficient to justify the loss of privacy and flexibility inherent in the stringent public access provisions.

However, some property owners who currently give public access think that some public access should be mandatory if a tax benefit is given. National Trust officials and some property owners suggested revising these provisions so that the degree of public access would vary depending on certain features, such as public interest in the property, its size, location, and contents. This is more in line with the public access provisions of the British system. As a general rule in Great Britain, access to the interior of smaller buildings is required about 30 days a year, and ranges from 60 to 156 days a year for larger buildings.

Finally, the extensive changes made in federal estate taxation since 1976 have reduced both the number of estates which are subject to tax and the amount of tax paid. Consequently, the adverse effects have already been reduced indirectly.

Provisions to Protect the Federal Government

Unlike the family farm provision in section 2032A of the Code, the proposal does not contain safeguards to protect the federal government's interest. The proposal does not contain provisions to (1) recapture the tax benefits if the historic property is not maintained as such, in perpetuity or for a period of time specified by the legislation; and (2) obligate the heirs or future owners to maintain the property as historic property. Also, the proposal would apply to all historic properties rather than be limited to the more selective Register of National Historic Landmarks properties which are monitored to ensure that they are adequately maintained.

Recapture Provisions

Although the estate tax law for family farms and closely held businesses provides for the recapture of federal estate tax benefits if the family fails to operate the farm or business as such for 10 years after the decedent's death, the proposal does not contain recapture provisions. The disposition provisions appear to apply only if the executor chooses to pay the tax in installments and provides for recapture only during the installment period. After the tax is paid, no recapture is available if the historic property is not preserved.

Without recapture provisions, estates may obtain the proposed benefits and provide inadequate maintenance for the historic properties. As currently proposed, estate owners benefiting from the reduced federal estate tax could pay the net tax on the due date and, immediately, abandon it as a historic property. Further, owners could abandon all maintenance efforts and let the property deteriorate to the point where its

historic features are lost forever. Recapture provisions are needed to ensure preservation and maintenance of historic property in perpetuity, or at least for a specified period of time.

Obligation of Heirs

The obligation of the heirs to maintain the transferred historic property raises a separate question: should the heirs be required to operate and maintain the historic property for a period of years after the decedent's death? If recapture provisions preclude the sale of the historic property for development purposes, the executor or the heirs may sell the historic portion of the estate as historic property and fulfill the preservation obligation. If the intent of the proposal is to preserve historic properties, regardless of who the owners may be, then this may be a valid issue only in determining who would be liable for the recaptured tax if the property is not preserved and maintained as historic property.

The question of who should be liable for recaptured tax, the heirs or the new owner, is addressed in the family farm and closely held business legislation by holding the family liable. If ownership is not a primary issue, the proposal could provide for transferring the preservation obligation to future owners in perpetuity or for a specified period of time.

Limitation of Proposal Provisions to National Historic Landmarks

The proposal targets most of the approximate 700,000 properties listed on the National Register of Historic Places. NPS and SHPOs do not routinely monitor these properties to ensure that they are adequately maintained, though they do monitor the 1,781 national historic landmarks. Limitation of proposed benefits to the national historic landmarks would target the benefits to properties of value to our national heritage, rather than to state or local places of interest. It would be easier for NPS to monitor the maintenance of historic property benefiting from the tax relief if the proposed benefits were granted only to estates containing national historic landmarks. However, NPS expects that the current number of landmarks would increase substantially if this were to happen.

The National Trust believes that all property on the National Register should be eligible for the proposed benefits.

Alternative Ways to Protect Historic Properties

In reviewing the literature and interviewing a variety of individuals, we identified alternatives to the proposal addressing concern over the impact of federal estate tax on the preservation of historic properties.

Tax Deferrals

Some historic property owners would like to have the federal estate tax on these properties deferred as long as the property is maintained as historic property and public access is provided. This is consistent with the system in Great Britain, where the government defers all national estate tax for as long as the owner maintains the property and grants public access. If the property is not maintained or public access is not provided, the current owner becomes liable for the full payment of the deferred estate tax.

Several property owners believe that estate tax deferral would increase the likelihood that historic property would remain in private ownership and be properly maintained. According to these owners, even with a deferral, money may not be available to pay estate tax if most of an owner's liquid assets have been used to maintain and improve the property. They believe that private ownership is the most efficient way for these properties to be preserved because state and local governments benefit from the property taxes. If the property is used as a business, federal and state income taxes may also be paid. If the property passes into public ownership, not only are these taxes foregone, but funds must also be provided for upkeep or eventually the property will be lost.

We were provided, on the other hand, with several examples of historic properties which did not remain in private ownership but were preserved. In some cases, the properties were acquired by state and local governments or preservation groups which opened the property to the public.

Education Programs to Encourage Effective Estate Planning

Even though current law provides for historic preservation easements to reduce the estate taxes on historic properties and provides time extensions for payment under certain conditions, estate tax legal experts said that property owners frequently do not use them in estate planning. Reasons given for this are that owners (1) wish to retain complete control of their properties, (2) consider the cost too high, (3) perceive that the procedure is too complicated, (4) have difficulty making the necessary decisions, or (5) may not be aware of these provisions.

One state historic preservation officer suggested that expanded education programs by NPS, the National Trust, or others could be useful in promoting the use of these provisions. Limited information from a few states indicates that their preservation programs vary widely. Alabama, for example, has recently initiated an "Endangered Properties Program," in which individuals can make a gift to the Alabama Historical Commission if the property is a "highly important piece." We were also told of states that make estate planning information available when requested but have no specific program in place. At least one state, Rhode Island, has an extensive program in place.

The Rhode Island preservation office, in response to inquiries about historic register designation, provides a fact sheet which includes information about easements. Rhode Island has an extensive state historic preservation program which not only provides educational material to interested parties but also targets specific properties for preservation, seeking out the owners and working with them to assure that the historical integrity of the property is retained. The state officials claim that the program has been very successful, as evidenced by the large number of historic properties preserved in that state.

GAO Letter of Inquiry

March 16, 1987

Dear

Senator Paul Trible has asked us to determine the extent to which historic properties in the United States have been broken up or sold for incompatible uses to pay federal estate taxes.

Our preliminary work has revealed that little data is available on this question at the national level. Therefore we are requesting the help of state preservation officers and local historical societies in identifying these properties. We are specifically interested in residential properties listed on the National Register of Historic Places, which since 1976 have been sold to pay estate taxes and subsequently altered such that they would no longer qualify for inclusion on the register.

If you have information on properties in this category we would greatly appreciate receiving it. Of particular use to us would be the location of the property and the name of the property owner at the time of sale or alteration. Any other specifics you may have, such as the name of the current property owner, and the date of the sale or alteration would be helpful.

Please address your replies to the attention of Helen Fauntleroy at the following address

U.S. General Accounting Office
1201 F Street, NW, Room 606
Washington, D.C. 20221

Or you can contact her or Mary Phillips by telephone at (202) 376-0023. We would very much appreciate having this information by the middle of April. Thank you for your assistance in this matter.

Sincerely yours,

Charles L. Vehorn
Group Director

*U.S. G.P.O. 1988-201-749:80037

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.